



# Find the hidden gems

Roger Montgomery illustrates how time spent on research can pay off

**M**ANAGING CAPITAL invested in the sharemarket can be intense. With around 2000 companies listed on the ASX and family commitments to contend with, it is just not feasible for many investors to thoroughly research everything. Even our full-time team of nine, who know where to look, still require models and systems to help us uncover the otherwise hidden gems.

To ensure as many opportunities as possible are discovered, some fund managers, including The Montgomery Fund, employ quantitative models. These models trowel databases of company information for metrics that are associated with high quality and good value. But relying solely on these screens is still not enough.

For starters, quantitative models analyse historical data to make their projections but future prospects are rarely identifiable from past results. And historical data may be distorted by events that might not be repeated. These are referred to by management as “one-offs” and a skilled and experienced analyst may have to sift through what the company deems is repeatable and what is not.

It is for these reasons that we dedicate considerable resources to filtering the screened results and also to searching for additional opportunities that might be overlooked by the quantitative models.

If we had relied purely on quantitative models to make our decisions, we would have missed the following gem.

Bentham IMF (ASX: IMF) is a class action litigation funder that listed on the ASX in 2001. At the end of the 2014 financial year, the company had commenced 159 cases in its history, of which 104 were settled, 14 were won in court, six were lost and 35 were withdrawn. This impressive track record translated into a gross return on investment of 273%.



Management is highly experienced at allocating resources during a case and maximising the pay-off for its clients but it cannot accurately predict how long a case will take to settle, win or lose. And because of the variability of case duration, income has historically been very lumpy.

This lumpiness has been reflected in the results from 2012 to 2014. Many investors (and basic stock screeners) might mistakenly believe profits are in decline: Bentham IMF generated a net profit after tax (NPAT) of \$43 million in 2012 but in 2013 earnings fell to \$13.8 million and then to \$9.9 million in 2014.

The company also raised equity in 2014 to fund cases that would settle in future years, and this diluted near-term shareholders' earnings.

You can see how a quantitative screen run at the end of the 2014 financial year might have failed to uncover Bentham IMF as a worthy candidate for investment. However, an investor who took the time

to analyse the company's business model would have discovered that management was positioning the company to achieve meaningful future growth.

While Bentham IMF's short-term earnings are volatile, its history gives a clear insight into the returns that can be generated from its claims book. At the end of the 2014 financial year, it had a claims book valued at about \$2 billion. Cases are settled in about three years on average, and the proceeds are about 50% of the estimated claims value. Bentham IMF charges a fee of 30% on these proceeds, two-thirds of which is recognised as income. With general expenses of around \$12 million, this would equate to annual after-tax earnings of around \$38 million. Bentham IMF's current market capitalisation is around \$380 million, which would imply an earnings yield of 10%.

Our valuation models suggest the shares are attractively priced and value remains – a rare thing in this expensive market. Management aspires to being a global litigation funder and has amassed a cash balance of \$100 million-plus to fund offshore cases. We also believe the company can increase its claims book to \$2.5 billion, predominantly from US class actions.

The company has just released its half-year 2015 financial results, in which it reported net profit after tax of \$23 million. Interest in the company is likely to increase after its improved profitability is identified in quantitative screens by private investors and fund managers. Having established positions for The Montgomery Fund after extensive research to identify the opportunity, we look forward to the rest of the market understanding Bentham IMF and, in turn, rewarding investors.

*Roger Montgomery is founder and CIO at The Montgomery Fund. For his book, Value. Able, see [www.rogermontgomery.com](http://www.rogermontgomery.com).*